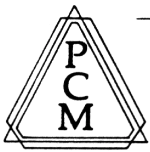

PERKINS
CAPITAL
MANAGEMENT, INC.

July 25, 2000

Dear PCM Client:

July again already and a pretty typical one at that. Hot, humid weather and more rain than we normally see in an entire summer. Half the year is gone and at the three-quarter mark we will be chasing ducks and then before you know it Christmas will be here.

IN SEARCH OF A WOODEN BIRD

By the time you receive this letter, Perk will be bidding on duck decoys at the Guyette and Schmidt auction, which is held annually in July at the Cliff House near Ogunquit, ME. This year Perk will start out at the Decoys Unlimited auction on Sunday, July 23 in Hyannis, MA. Although smaller than the Guyette and Schmidt auction, there will be some interesting birds to look at and possibly bid on. Last year the Kennedy airplane crashed into the sea the day before the auction, so that tragedy was the subject of conversation at Hyannis rather than the auction. But Perk was unable to stay for the Hyannis auction, for during the night Dana's mother, Chris, suffered a stroke; Perk caught the first plane he could to Minneapolis on Sunday morning, but Chris had passed away before he arrived home. This day was very sad, for Chris was loved and admired by everyone. Her friends and family miss her; it is hard to believe a year has passed since that sad event.

Following this year's Hyannis auction Perk plans to drive to Shelburne, VT, to visit the Shelburne Museum, which contains the most prestigious collection of decoys in the world. There are other great decoy collections - - the Lakeview Museum of Arts & Science collection in Peoria and, of course, the world-renowned Ward Museum in Salisbury, MD, but they pale in comparison. Perk has never been to see the Shelburne collection, so this will be a highlight of the trip. And then he will head to Ogunquit for the dealer show on Wednesday, July 26 and the auction on July 27 and 28. This is quite an event with 700 decoys going under the gavel. Looking at the catalog, one can see that the price estimates range from $150 for a mallard by an unknown carver to $60,000 for a Ward pintail drake, circa 1920s.

There are numerous decoy auctions held each year, but the three most prominent and best attended are the Guyette and Schmidt auctions held in April at the Pheasant Run Resort in St. Charles, IL, in July at the Cliff House in Ogunquit, ME and in November at the Talbot Community Center in Easton, MD. The Harmons have their Decoys Unlimited auction in Hyannis each July, and the Frank and Frank auction is held in October in Belmar, NJ. And there are others held from time to time. In our January letter we wrote about the Sotheby's auction which set a record for decoy prices. As you may imagine those prices have elevated the prices paid at future auctions, as well as the value of

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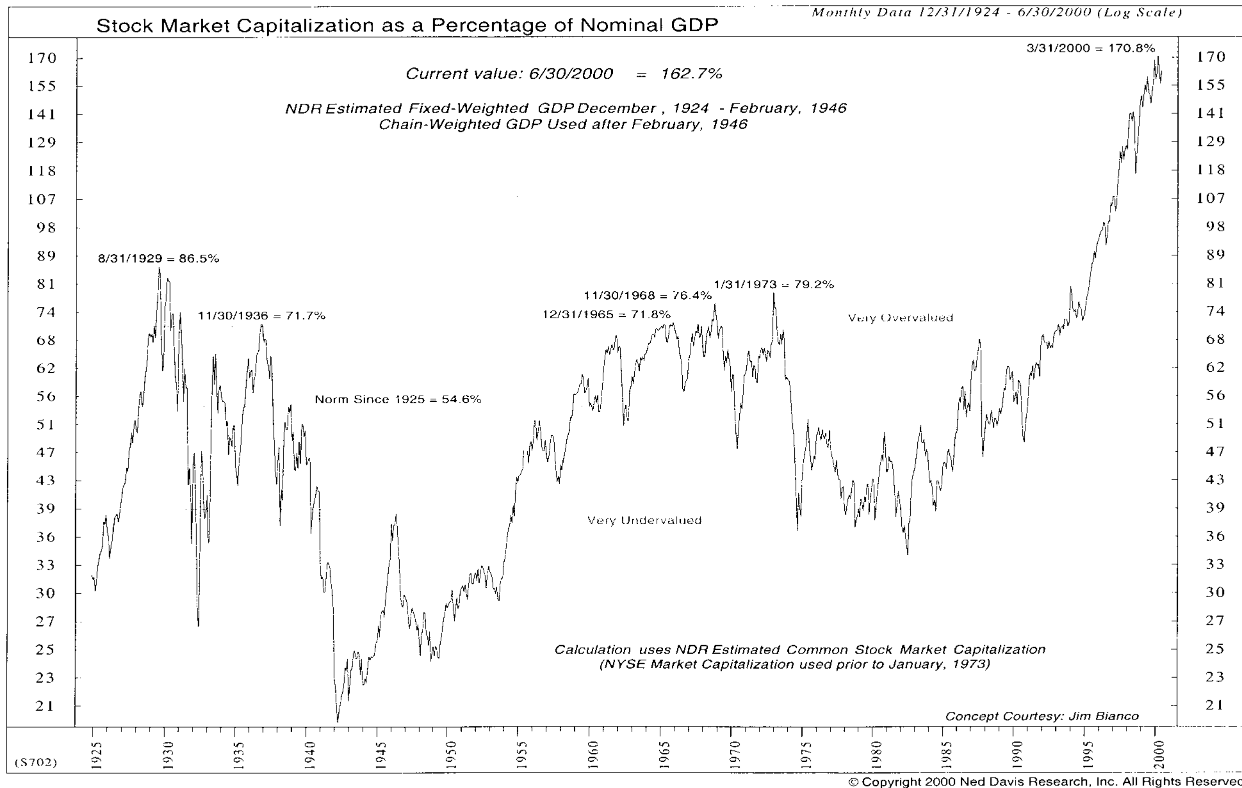
collections such as Perk's, which now numbers in excess of 300 ducks, 20 swans, 25 Canadian geese and many owls, crows and shore birds. Those of you who have seen Perk's collection know that his problem is space - - he has no more room, not even for one single bird. They are stuffed into every nook and cranny at the office, at his home and at Dumbbell Lodge, the Northern Minnesota hideaway. The advice he receives from friends, other collectors and dealers is universally the same - - get rid of the lower quality ones and upgrade to better decoys by known carvers, as they will go up more in value over time. Easier said than done, however, because Perk likes each one of them.

WHAT GOES AROUND COMES AROUND

In recent letters we have put forth our opinion that the market today reminds us of the 1970-72 period, which was a topping area, the culmination of the extended rise off the 1966 bottom. This resulted in extreme valuations of "blue-chip" stocks, the so-called Nifty Fifty, which despite their extreme P/E ratios were looked at as one decision stocks which, although perhaps temporarily overvalued, would always grow and therefore could be held through thick and thin. Of course, it turned out that this was hogwash. In our last letter (April 26) we produced a chart of McDonald's showing that overvaluation is just that - - overvaluation - - and that the stock went from an 85 P/E in 1972 to a 9 P/E in 1980, despite continued rising earnings without any blips. This can all happen again, and in our opinion will, before the market finds a true bottom, which we don't think will arrive until the summer/fall of 2002, or about the time the 20-year cycle is due to bottom. Markets, as we all know, (or should by now) reflect the hopes and fears of investors as much or more than they reflect the underlying fundamentals. In other words, psychology is more important than physiology! Expectations take valuations far beyond what the fundamentals should allow and on the other side far below what the fundamentals should call for. At times everyone wants to own certain groups within the market. For example, in 1980-81 everyone wanted to own energy stocks because the common expectation was that the price of oil would rise indefinitely. Past trends of oil price increases were projected into the future, with no basis in fact, but only the human emotion (frailty) of maintaining the status quo and an unwillingness to go contrary to the general expectation. We remember projections of $50 to $100 a barrel for oil, but just at about that time the peak was reached at $40. At this same time the crowd did not want to own consumer growth stocks (the Nifty Fifty, which had declined dramatically in price following the 1972-73 top) because expectations had been lowered by many years of poor price performance. Remember, we just pointed out that McDonald's went from an 85 P/E to a 9 P/E from 1972 to 1980. All of this action was a set-up for a "sea change" in the market, where what everybody owned and expected to do well (e.g. energy) did poorly for years, while what investors had given up on and expected to do poorly (e.g. consumer) was the best place to be for several years to come. It seems to us that it is time for another major shift and that the winning sectors of recent years, namely large-cap technology, Internet and communication stocks have reached peaks in valuation (not necessary earnings) and therefore performance which may stand for many years to come. Please refer again to page eight of our April 26 letter to see this P/E expansion illustrated in four stocks: General Electric, Automatic Data Processing, Cisco Systems and Veritas Software. **And so, once again we think it is**

time for a major valuation shift, perhaps to a small group of "old economy" stocks, but almost certainly to small and micro-cap stocks, which have been tossed aside during this 5-year flight to large-cap high-tech, Internet and communications stocks. Another way of looking at overvaluation other than P/E ratios or dividend yields is a comparison of the total stock market capitalization to gross domestic product. The chart below shows clearly the rise in valuations which began in 1995 from what was an already overvalued level, the approximate level that existed in 1972-73 prior to the extreme drop into the 1974 bear market bottom. We think there are many extreme levels of valuation today. Remember, it takes buying to put stocks up, but they can fall of their own weight.



Others have picked up on the same excess valuation theme. For example, Andrew Smithers and Stephen Wright have written a new book titled *Valuing Wall Street*, in which they argue that James Tobin's **q** ratio, which is essentially the total value of the stock market divided by corporate net worth, is by far the best measure available for determining whether the market is over- or undervalued. Using that yardstick, they calculate that the overall market is 2.5 times its average value. Their critics, of course, argue that if so, the market has been overpriced for several years and has advanced significantly from 1995, although at that time it was considered to be fairly valued. Likewise, Robert Shiller's book, *Irrational Exuberance,* argues that expectations today are so optimistic that stock valuations are easily at their highest in the last 150 years, and he points out that while corporate profits have risen 60% since 1994, stock prices have more than tripled. Robert Shiller, by the way, is the professor who coined the phrase "irrational exuberance," which he gave to Allan Greenspan in late 1996. So, contrary to popular belief, it wasn't Greenspan who thought up the phrase.

WHAT GOES AROUND COMES AROUND I I

All of us, we are sure, have enjoyed the famous M&M candies; they're Perk's favorite. Recently he saw that plain M&M's are now called Milk Chocolate rather than Plain, as they had been all along. Later he found out why in a *New York Times* article, which described the situation as only the *New York Times* can. It turns out that when M&M's were introduced in 1941, they were called Milk Chocolate, but in 1954 when the peanut variety was introduced they became "Plain" to make way for peanut M&M's. So, it turns out, the M&M marketing executives have been laboring for 46 years over the fact that the word plain says things like dull, boring, ordinary or simple. Evidently they were finally motivated to do something about it, so now the M&M advertising character declares "I am not a Plain M&M, I am a Milk Chocolate M&M."

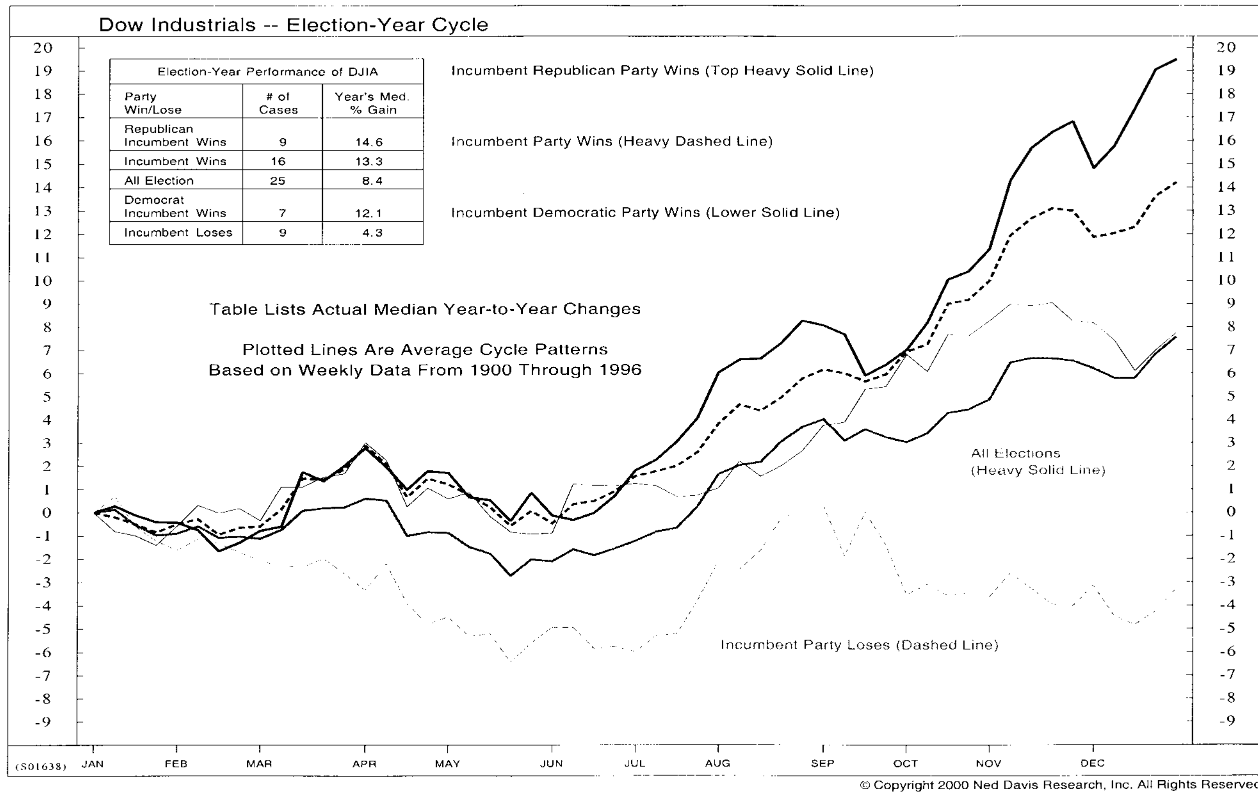
So in the end, what goes around does come around, but in this case it took 46 years.

QUE SERA SERA

Doris Day, who hailed from Cincinnati, Ohio, where her name was Doris Mary Ann Von Kappelhoff, made that song famous:

> When I was just a little girl
> I asked my mother, what will I be
> Will I be pretty, will I be rich
> Here's what she said to me.
>
> Que Sera, Sera,
> Whatever will be, will be
> The future's not ours to see
> What will be, will be

And what is the near term future of the stock market? For the rest of the year? Experienced market letter writers always make sure their advice can be interpreted more than one way, i.e., they can show they were right regardless of what happens. We don't want to suggest that we are trying to do that, but we do have a bit of a dilemma as we write this. On the one hand, we know from history that the election year cycle looks for a bottom in midsummer, while on the other hand, there are other factors such as the 6% discount rate, which say the market should decline. Shown on the next page is a chart which summarizes market action of the Dow Jones in all election years from 1900 through 1996. It clearly shows what we have illustrated in previous election years, namely that the last half of an election year is usually pretty good for the market. As can be seen, the market does best if the incumbent Republican Party wins and the worst when the incumbent party loses. So if we can predict the election, perhaps we can tell the market's future, at least over the near term.



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But the May increase in the discount rate gives us pause, as history clearly shows that whenever the discount rate has gone to 6% or higher, the market has taken it on the chin. There have been six prior instances since 1920 when this happened; the seventh was this May. In five of the six, as shown in the table, the market was lower one year later and in four of the six, six months later and in all cases one year later. In two of the instances, namely 1973 and 1977, the declines were not significant, but in the other four years, they were. This is also illustrated in the chart on the next page,

Raise to 6% Discount Rate

Days Out	Mean	Median
1	-0.02	0.00
5	0.69	1.17
10	0.26	0.02
91	-12.80	-11.33
126	-11.32	-11.78
253	-17.42	-17.00

All Market Days

Days Out	Mean	Median
1	0.03	0.05
5	0.13	0.24
10	0.26	0.46
91	2.44	2.79
126	3.43	3.71
253	7.28	6.53

Date	1-day % Change	5-day % Change	10-day % Change	91-day % Change	126-day % Change	253-day % Change
01/23/1920	0.74	1.67	-4.58	-10.35	-10.75	-25.24
08/09/1929	2.03	4.86	8.15	-22.05	-26.83	-37.32
04/03/1969	-0.92	0.66	-0.27	-12.30	-12.82	-14.63
05/11/1973	-1.97	-3.54	0.31	-0.80	0.50	-8.88
10/26/1977	0.64	-1.54	0.62	-7.69	1.66	0.95
09/04/1987	-0.64	2.02	-2.68	-23.63	-19.72	-19.37

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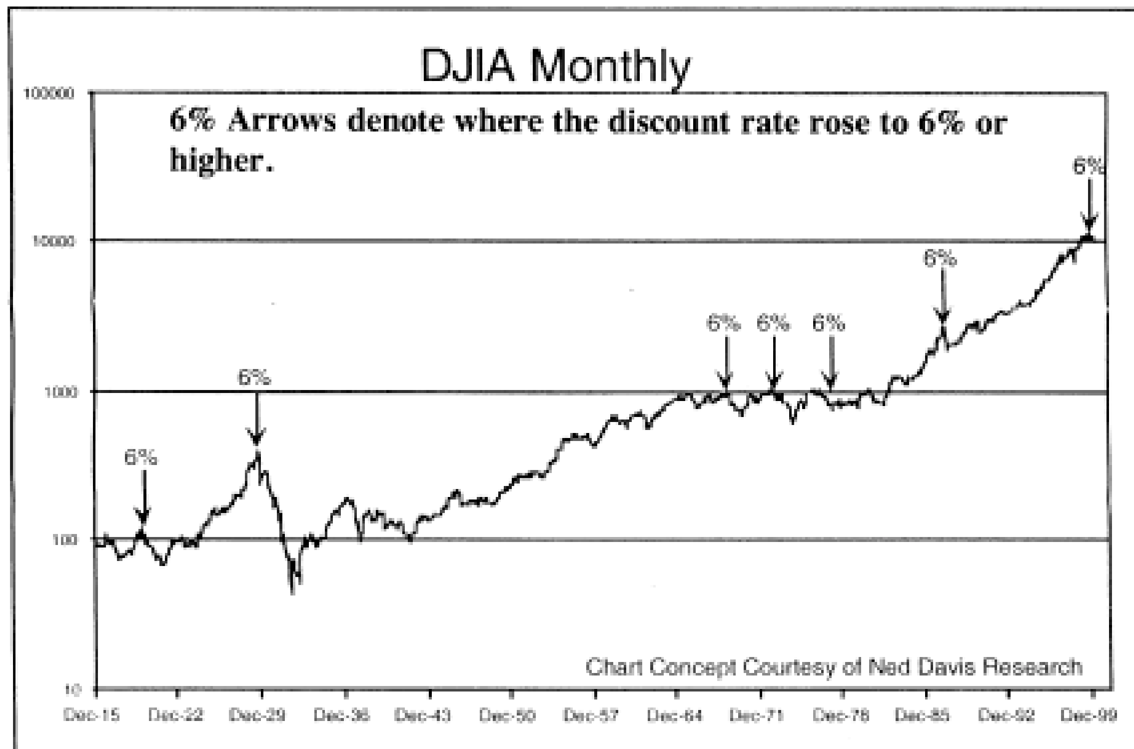

which pinpoints the declines. Considering our previous dissertation about the overvaluation in the market, we think that there is considerable downside risk staring at us in the overvalued sectors which we have previously mentioned.

Que Sera Sera.

IF IT AIN'T BROKEN, DON'T BREAK IT

We are talking about Microsoft, of course, and the goal of breaking up the most successful new business in history. They say Microsoft broke the law and Judge Jackson criticized Microsoft and its judgment for failing to admit that it did break the law. But Bill Bonner, author of *Daily Reckoning* (www.dailyreckoning.com), had the following to say:

> "What Law? Whom did Bill Gates & Co. murder? From whom did they steal? When did they bear false witness? Ah, but it was not the law of Moses nor any provision, big or small, of common law that MSFT transgressed. It was the law writ by politicians and interpreted by bureaucrats - that is to say, the law of fools and knaves - that Judge Jackson applies. Anti-Trust, it is called. A refuge of legal humbuggery if there ever was one. Had Bill Gates been a big contributor to political campaign coffers and spent his time currying favor in Washington rather than providing the world with useful products - no case would have ever

been launched against the company and Judge Jackson might be spending his time locking up people for, say, littering federal highways."

We are inclined to agree, and looked up the results of a previous Justice Department action in which a high-tech company was charged with abusing market power. This was the infamous IBM anti-trust case, which was filed by Attorney General Ramsey Clark in January 1969, literally on the last business day of Lyndon Johnson's administration. It finally ended 13 years later when the Reagan administration dismissed the case as "without merit." During that 13-year span, IBM's share of the data processing market fell from 47% in 1969 to 33% in 1972. Did prolonged government interference cost IBM the lead in a new generation of personal computers? There are those that think so. Certainly, a lot of executive time was sidetracked to battle the government to say nothing of the expense. In the end US citizens were the big losers, plus lots of opportunity at IBM, which has never been the same since. The IBM case was built on the notion that high market share equals a monopoly and that a monopoly in itself is illegal. But today monopolies are legal; what is illegal, according to the Justice Department, is using anti-competitive means to protect a monopoly position. Today there are other operating systems, the most promising of which is Linux. Obviously, the Department of Justice believes Linux is a technological heir apparent to Windows, and one that could become a challenge. Already China is backing the Linux system in a major setback to Microsoft's world dominance. According to a recent *New York Times* article, the Chinese government tried for more than a decade to develop an operating system of its own, but was unable to keep up with the fast changing industry. Linux gives them the tools to build that system now and, in the Chinese view, the fact that the Linux code is not privately held assures that any security that it wants to build into its computer systems will not have undetectable vulnerabilities. China represents a market potential of such size and government influence over the market is so strong that Chinese support can turn almost any product into an industry standard. By the end of next year, the country may well be the third largest PC market in the world and software sales are expected to grow more than 30% a year for the foreseeable future. The point of all of this, of course, is that Microsoft may well lose the monopoly position which its Windows operating system enjoys today and it may not be just because of the break-up.

The stock market has not been kind to Microsoft during this long battle with the Justice Department. It reached a high of 120 in December 1999 and within five months was cut exactly in two to 60 in May 2000, but since then has recovered to about 75. We thought the cartoon was especially funny in light of the fact that the drop in Microsoft cost Bill Gates billions in paper profits.

PROGRESS IN THE UNITED KINGDOM

There is very good news from Great Britain. As any tourist knows, the pubs (yes, all 60,000) close at 11:00 p.m. weekdays and 10:30 p.m. on Sunday. This rule goes way back to World War I when pub hours were restricted to prevent munition workers from getting drunk and then using poor judgement on munition assembly lines and blowing up the factories. Now, more than 80 years later, the Home Office has issued proposals to simplify the licensing laws, allowing most pubs to serve alcohol 24 hours a day. At its usual snail's pace, Parliament will not hear this proposal until 2001 at the earliest, but at least the first step has been taken. The UK government has always been slow to respond to changes in the work and leisure habits of the populous, as it wasn't until 1994 that most stores were allowed to open on Sunday.

There is also more change to report. Since his early days as an institutional analyst/salesman serving the overseas markets for Piper Jaffray, Perk has been a member of the prestigious City of London Club located in Old Broad Street, having been recommended for membership by two member/client friends, Colonel Teddy Butler Henderson and Samuel Stevenson. Perk either had failed to read the dress code rules or had forgotten them, and on a trip to London perhaps 12 or 13 years ago, Perk and Dana had taken another member, Peter Rintoul, and his wife, Anne, to lunch there in the VIP room. After lunch was finished and they were on their way to the second floor lounge for coffee and an after-lunch sherry, Peter, who was also a member, was taken aside and told that we should leave because Perk was violating the dress code. Hello! Perk was in a blue shirt, tie, blue sport coat and gray slacks, which was inappropriate and in violation of the dress code, which required a "proper" business suit. And so we left with Perk suitably embarrassed. Now, however, the June Club newsletter brought the news that the dress code is being relaxed. Quoting from that letter: "Regulation 3 of the Club rules presently states that male Members and their male guests are required to wear suits. The House Committee has decided to amend this regulation to the following: Members and their male guests are encouraged to wear a suit, with a collared shirt and tie. However, smart dark trousers and dark jacket or dark blazer, with a collared shirt and tie, may be worn. Lady guests are required to wear dresses, suits or trouser suits. Tweed jackets, shooting jackets, casual trousers and casual shoes are not permitted. Interpretation of this regulation is at the discretion of the Secretary."

As we said, great progress. Not as far as the Minneapolis Club has gone, however, where the dress code adopted January 1, 1997 states that while a blazer, sport coat or suit is

mandatory at breakfast or lunch, a tie is optional. This is considered to be "Business Casual." A suit and tie is still mandatory at dinner.

HONG KONG DISCOVERS TP

We received many compliments on Bridget's e-mail from Hong Kong, which was an attachment to our last letter. We passed them all on to her. Bill Bonner even wondered if she would like a job writing. And, actually, she has interviewed for a reporter position with a small town newspaper in Oregon. Anyway, her views of Hong Kong were not only accurate but well presented and so when we saw a *USA Today* article which said that the Hong Kong government, in an effort to be more visitor friendly, is going to put toilet paper rolls in the public toilets, we thought that was a noteworthy item. The Hong Kong Standard, noting that paper use in public restrooms is "not a common Asian practice" says that the initial effort will target 23 public facilities in the most tourist trafficked areas, such as the Star Ferry Terminal, the Peak Tower and Stanley Market, but the remainder of the 286 public loos will have to wait. Evidently, tourists have been making a stink about this problem for decades and surprisingly it's taken since 1995 to get this far. Under British rule the territory created a "public toilet improvement scheme" then that brought renovations to the facilities, but no toilet paper. Well, at least there are going to be 23 public toilets where you can find T.P. The other 263 will have to wait. We were wondering, are there corncobs in Hong Kong? Or Sears catalogs?

MORE FUNNY E-MAIL

We continue to get more than our fair share of jokes and other humorous things over that wonderful invention called e-mail. The one that follows came from Dottie Hoel.

Great Truths About Life That Little Kids Have Learned:

1) No matter how hard you try, you can't baptize cats.

2) When your mom is mad at your dad, don't let her brush your hair.

3) If your sister hits you, don't hit her back. They always catch the second person.

4) Never ask your 3-year old brother to hold a tomato.

5) You can't trust dogs to watch your food.

6) Reading what people write on desks can teach you a lot.

7) Don't sneeze when someone is cutting your hair.

8) Puppies still have bad breath, even after eating a tic-tac.

9) Never hold a Dust-Buster and a cat at the same time.

10) You can't hide a piece of broccoli in a glass of milk.

GRAHAM AND DODD REVISITED

In a recent letter we commented that the bible for technicians is *Technical Analysis of Stock Trends* written in 1948 by Robert Edwards and John Magee and that the bible for fundamental analysts is *Security Analysis* written in 1934 by Benjamin Graham and David Dodd. It still may be the case today, but for sure when Perk was at the University, investment courses used *Security Analysis* as a basic text. An October 1999 supplement to the Elliott Wave Theorist contained a reprint of a section of that classic book which had been cut from later editions; it is not part of the one Perk has and he graduated in 1956. We are reprinting this section of *Security Analysis* as our addendum to this month's letter. This section of the book addresses the change in investor thinking toward stock valuation that occurred in the late 1920s during that great stock mania. As shown in the chart on page three of this letter, the market's valuation today is well above where it was at the high point in 1929, yet the excuse for today's overvaluation is the same as it was then; companies where earnings can continue to increase should be owned regardless of price. The beginning of these pages is started in the space normally reserved for a cartoon and then continues for several pages further over leaf.

Sincerely,

Richard W. Perkins, C.FA.
President
Senior Portfolio Manager

Daniel S. Perkins, C.F.A.
Vice President
Portfolio Manager

Richard C. Perkins, C.F.A.
Vice President
Portfolio Manager

RWP:DSP:RCP/jah

Excerpt from Security Analysis *(1934), by Benjamin Graham and David Dodd, p. 306:*

***Investment in Common Stocks Based on Threefold Concept.*—We thus see that investment in common stocks was formerly based upon the threefold concept of: (1) a suitable and established dividend return; (2) a stable and adequate earnings record; and (3) a satisfactory backing of tangible assets. Each of these three elements could be made the subject of careful analytical study viewing the issue both by itself and in comparison with others of its class. Common-stock commitments motivated**

by any other viewpoint were characterized as speculative, and it was not expected that they should be justified by a serious analysis.

THE NEW-ERA THEORY

During the postwar period, and particularly during the latter stage of the bull market culminating in 1929, the public acquired a completely different attitude towards the investment merits of common stocks. Two of the three elements above stated lost nearly all of their significance and the third, the earnings record, took on an entirely novel complexion. The new theory or principle may be summed up in the sentence: "The value of a common stock depends entirely upon what it will earn in the future."

From this dictum the following corollaries were drawn:

1. That the dividend rate should have slight bearing upon the value.
2. That since no relationship apparently existed between assets and earning power, the asset value was entirely devoid of importance.
3. That past earnings were significant only to the extent that they indicated what *changes* in the earnings were likely to take place in the future.

This complete revolution in the philosophy of common-stock investment took place virtually without realization by the stock-buying public and with only the most superficial recognition by financial observers. An effort must be made to reach a thorough comprehension of what this changed viewpoint really signifies. To do so we must consider it from three angles, its causes, its consequences, and its logical validity.

Causes for This Changed Viewpoint.--Why did the *investing* public turn its attention from dividends, from asset values, and from earnings, to transfer it almost exclusively to the earnings *trend, i.e.,* to the *changes* in earnings expected in the future? The answer was, first, that the records of the past were proving an undependable guide to investment; and secondly, that the rewards offered by the future had become irresistibly alluring.

The new-era concepts had their root first of all in the obsolescence of the old-established standards. During the last generation the tempo of economic change has been speeded up to such a degree that the fact of being *long established* has ceased to be, as once it was, a warranty of *stability.* Corporations enjoying decade-long prosperity have been precipitated into insolvency

within a few years. Other enterprises, which had been small or unsuccessful or in doubtful repute, have just as quickly acquired dominant size, impressive earnings, and the highest rating. The major group upon which investment interest was chiefly concentrated, *viz.,* the railroads, failed signally to participate in the expansion of national wealth and income, and showed repeated signs of definite retrogression. The street railways, another important medium of investment prior to 1914, rapidly lost the greater portion of their value as the result of the development of new transportation agencies. The electric and gas companies followed an irregular course during this period, since they were harmed rather than helped by the war and postwar inflation, and their impressive growth is a relatively recent phenomenon. The history of industrial companies was a hodge-podge of violent changes, in which the benefits of prosperity were so unequally and so impermanently distributed as to bring about the most unexpected failures alongside of the most dazzling successes.

In the face of all this instability it was inevitable that the threefold basis of common-stock investment should prove totally inadequate. Past earnings and dividends could no longer be considered, in themselves, an index of future earnings and dividends. Furthermore, these future earnings showed no tendency whatever to be controlled by the amount of the actual investment in the business-the asset values-but instead depended entirely upon a favorable industrial position and upon capable or fortunate managerial policies. In numerous cases of receivership, the current assets dwindled and the fixed assets proved almost worthless. Because of this absence of any connection between both assets and earnings, and between assets and realizable values in bankruptcy, less and less attention came to be paid either by financial writers or by the general public to the formerly important question of "net worth," or "book value," and it may be said that by 1929 book value had practically disappeared as an element in determining the attractiveness of a security issue. It is a significant confirmation of this point that "watered stock," once so burning an issue, is now a forgotten phrase.

Attention Shifted to the Trend of Earnings.--Thus the prewar approach to investment, based upon past records and tangible facts, became outworn and was discarded. Could anything be put

in its place? A new conception was given central importance - that of *trend of earnings.* The past was important only in so far as it showed the direction in which the future could be expected to

move. A continuous increase in profits proved that the company was on the upgrade and promised still better results in the future than had been accomplished to date. Conversely, if the earnings had declined, or even remained stationary during a prosperous period, the future must be thought unpromising and the issue was certainly to be avoided.

The Common-stocks-as-long-term-investments Doctrine.- Along with this ideas as to what constituted the basis for common-stock selection, there emerged a companion theory that common stocks represented the most profitable and therefore the most desirable media for long-term investment. This gospel was based upon a certain amount of research, showing that diversified lists of common stocks had regularly increased in value over stated intervals of time for many years past. The figures indicated that such diversified common-stock holdings yielded both a higher income return and a greater principal profit than purchases of standard bonds.

The combination of these two ideas supplied the "investment theory" upon which the 1927-1929 stock market proceeded. Amplifying the principle stated on page 307, the theory ran as follows:

1. "The value of a common stock depends on what it can earn in the future."
2. "Good common stocks will prove sound and profitable investment."
3. "Good common stocks are those which have shown a rising trend of earnings."

These statements sound innocent and plausible. Yet they concealed two theoretical weaknesses which could and did result in untold mischief. The first of these defects was that they abolished the fundamental distinctions between investment and speculation. The second was that they ignored the *price* of a stock in determining whether it was a desirable purchase.

New-era Investment Equivalent to Prewar Speculation.-A moment's thought will show that "new-era investment," as practiced by the representative investment trusts, was almost identical with speculation as popularly defined in preboom days. Such "investment" meant buying common stocks instead of

bonds, emphasizing enhancement of principal instead of income, and stressing the changed of the future instead of the facto f the established past. It would not be inaccurate to state that new-era investment was simply old-style speculation confined to common stocks with a satisfactory trend of earnings. The impressive new concept underlying the greatest stock-market boom in history appears to be no more than a thinly disguised version of the old cynical epigram: "investment is successful speculation."

Stocks Regarded as Attractive Irrespective of Their Prices.- The notion that the desirability of a common stock was entirely independent of its price seems incredibly absurd. Yet the new-era theory led directly to this thesis. If a public0utility stock was selling at 35 times is *maximum* recorded earnings, instead of 10 times its *average* earnings, which was the preboom standard, the conclusion to be drawn was not that the stock was now to high but merely that the standard of value had been raised. Instead of judging the market price by established standards of value, the new era based its standards of value upon the market price. Hence all upper limits disappeared, not only upon the price at which a stock *could* sell, but even upon the price at which it would *deserve* to sell. This fantastic reasoning actually led to the purchase for investment at $100 per share of common stocks earning $2.50 per share. The identical reasoning would support the purchase of these same shares at $200, at $1,000, or at any conceivable price.

An alluring corollary of this principle was that making money in the stock market was now the easiest thing in the world. It was only necessary to by "good" stocks, regardless of price, and then let nature take her upward course. The results of such a doctrine could not fail to be tragic. Countless people asked themselves, "Why work for a living when a fortune can be made in Wall Street without working?" The ensuing migration from business into the financial district resembled the famous gold rush to the Klondike, with the not unimportant difference that there really was gold in the Klondike.

Investment Trusts Adopted This New Doctrine.-An ironical sidelight is thrown on this 1928-1929 theory by the practice of the investment trusts. These were formed for the purpose of giving the untrained public the benefit of expert administration of its fund-a plausible idea, and one which had been working

well in England. The earliest American investment trusts laid considerable emphasis upon certain time-tried principles of successful investment, which they were much better qualified to follow than the typical individual. The most important of these principles were:

1. To buy in times of depression and low prices, and to sell out in times of prosperity and high prices.

2. To diversify holdings in many fields and probably in many countries.
3. To discover and acquire undervalued individual securities as the result of comprehensive and expert statistical investigations.

The rapidity and completeness with which these traditional principles disappeared from investment-trust technique is one of the many marvels of the period. The idea of buying in times of depression was obviously inapplicable. It suffered from the fatal weakness that investment trusts could be organized only in good time, so that they were virtually compelled to make their initial commitments in bull markets. The idea of worldwide geographical distribution had never exerted a powerful appeal upon the provincially minded Americans (who possibly were right in this respect); and with things going so much better here than abroad this principle was dropped by common consent.

Analysis Abandoned by Investment Trusts.-But most paradoxical was the early abandonment of research and analysis in guiding investment-trust policies. However, since these financial institutions owed their existence to the new-era philosophy, it was natural and perhaps only just that they should adhere closely to it. Under its canons investment had now become so beautifully simple that research was unnecessary and statistical data a mere encumbrance. The investment process consisted merely of finding prominent companies with arising trend of earnings, and then buying their shares regardless of price. Hence the sound policy was to buy only what every one else was buying - select list of highly popular and exceedingly expensive issues, appropriately known as the "blue chips." The original idea of searching for the undervalued and neglected issues dropped completely out of sight. Investment trusts actually boasted that their portfolios consisted exclusively of the active and standard (*i.e.,* the most popular and highest priced) common stocks. With but slight exaggeration, it might be asserted that under this convenient technique of investment,

the affairs of a ten-million-dollar investment trust could be administered by the intelligence, the training, and the actual labors of a single thirty-dollar-a-week clerk.

The man in the street, having been urged to entrust his funds to the superior skill of investment experts--for substantial compensation--was soon reassuringly told that the trusts would be careful to buy nothing except what the man in the street was buying himself.

The Justification Offered.-Irrationality could go no further; yet it is important to note that mass speculation can flourish only in an atmosphere of illogic and unreality. The self-deception of the mass speculator must, however, have its elements of justification. This is usually some generalized statement, sound enough within its proper field, but twisted to fit the speculative mania. In real-estate booms, the "reasoning" is usually based upon the inherent permanence and growth of land values. In the new-era bull market, the "rational" basis was the record of long-term improvement shown by diversified common-stock holdings.

A Sound Premise Used to Support an Unsound Conclusion. There was, however, a radical fallacy involved in the new-era application of this historical fact. This should be apparent from even a superficial examination of the data contained in the small and rather sketchy volume from which the new-era theory may be said to have sprung. The book is entitled *Common Stocks as Long-Term Investments,* by Edgar Lawrence Smith, published in 1924. Common stocks were shown to have a tendency to increase in value with the years, for the simple reason that they earned more than they paid out in dividends, and thus the reinvested earnings added to their worth. In a representative case, the company would earn an average of 9%, pay 6% in dividends, and add 3% to surplus. With good management and reasonable luck the fair value of the stock would increase with its book value, at the annual rate of 3% *compounded.* This was, of course, a theoretical rather than a standard pattern; but the numerous instances of results poorer than "normal" might be offset by examples of more rapid growth.

The attractive ness of common stocks for the long pull thus lay essentially in the fact that they earned more than the bond-interest rate upon their cost. This would be true, typically, of a stock earning $10 and selling at $100. But as soon as the price

was advanced to a much higher price in relation to earnings, this advantage disappeared, *and with it disappeared the entire theoretical basis for investment purchases of common stocks.* When investors paid $200 per share for a stock earning $10, they were buying an earning power no greater than the bond-interest rate, without the extra protection afforded by a prior claim. Hence in using the past performances of common stocks as the reason for paying prices 20 to 40 times their earnings, the new-era exponents were starting with a sound premise and twisting it into a woefully unsound conclusion.

In fact their rush to take advantage of the inherent attractive-ness of common stocks itself produced conditions entirely different from those which had given rise to this attractiveness and upon

which it basically depended, *viz.*, the fact that earnings had averaged some 10% on market price. As we have seen, Edgar Lawrence Smith plausibly explained the growth of common-stock values as arising from the building up of asset values through the reinvestment of surplus earnings. Paradoxically enough, the new-era theory which exploited this finding refused to accord the slightest importance to the asset values behind the stocks it favored. Furthermore, the validity of Mr. Smith's conclusions rested necessarily upon the assumption that common stocks could be counted on to behave in the future about as they had in the past. Yet the new-era theory threw out of account the past earnings of corporation except in so far as they were regarded as pointing to a *trend* for the future.

Examples Showing Emphasis on Trend of Earnings.-Take three companies with the following exhibits:

EARNINGS PER SHARE

Year	Company A (Electric Power & Light)	Company B (Bangor & Aroostook R.R.)	Company C (Chicago Yellow Cab)
1925	$1.01	$6.22	$5.52
1926	1.45	8.69	5.60
1927	2.09	8.41	4.54
1928	2.37	6.94	4.58
1929	2.98	8.30	4.47
5-year average	$1.98	$7.71	$4.47
High Price, 1929	86 5/8	90 3/8	35

The 1929 high prices for these three companies show that the new-era attitude was enthusiastically favorable to Company *A*, unimpressed by Company *B,* and definitely hostile to Company *C.* The market considered Company *A* shares worth more than twice as much as Company *C* shares, although the latter earned 50% more per share than Company *A* in 1929 and its average earnings were 150% greater.

Average versus Trend of Earnings.-These relationships between price and earnings in 1929 show definitely that the past exhibit was no longer a measure of normal earning power but merely a weathervane to show which way the winds of profit were blowing. That the *average earnings* had ceased to be a dependable measure of future earnings must indeed be admitted, because of the greater instability of the typical business to which we have previously alluded. But it did not follow at all that the *trend of earnings* must therefore be a more dependable guide than the *average;* and even if it were more dependable it would not necessarily provided a safe basis, entirely by itself, for investment.

The accepted assumption that because earnings have moved in a certain direction for some years past they will continue to move in that direction, is fundamentally no different from the discarded assumption that because earnings averaged a certain amount in the past they will continue to average about that amount it the future. It may well be that the earnings *trend* offers a more dependable clue to the future than does the earnings average. But at best such an indication of future results is far from certain, and, more important still, there is no method of establishing a logical relation ship between trend and price.[1] This means that the value placed upon a satisfactory trend must be wholly arbitrary, and hence speculative, and hence inevitably subject to exaggeration and later collapse.

Danger in Projecting Trends into the Future.-There are several reasons why we cannot be sure that a trend of profits shown in the past will continue in the future. In the broad economic sense, there is the law of diminishing returns and of

increasing competition which must finally flatten out any sharply upward curve of growth. There is also the flow and ebb of the business cycle, from which the particular danger arises that the earnings curve will look most impressive on the very eve of a serious setback. Considering the 1927-1929 period we observe that since the trend-of-earnings theory was at bottom only a pretext to excuse rank speculation under the guise of "investment," the profit-mad public was quite willing to accept the flimsiest evidence of the existence of a favorable trend. Rising earning for a period of five, or four, or even three years only, were regarded as an assurance of uninterrupted future growth and a warrant for projecting the curve of profits indefinitely upward.

Example: The prevalent heedlessness on this score was most evident in connection with the numerous common-stock flotations during this period. The craze for a showing of rising profits resulted in the promotion of many industrial enterprises which had been favored by temporary good fortune and were just

[1] The new-era investment theory was conspicuously reticent on the mathematical side. The relationship between price and earnings, or price and trend of earnings was anything that the market pleased to make it (note the price of Electric Power and Light compared with its earnings record given on p. 313). If an attempt were to be made to give a mathematical expression to the underlying idea of valuation, it might be said that it was based on the *derivative* of the earnings, stated in terms of Time.

approaching, or had already reached, the peak of their prosperity. A typical example of this practice is found in the offering of preferred and common stock of Schletter and Zander, Inc., a manufacturer of hosiery (name changed later to Signature Hosiery Company). The company was organized in 1929, to succeed a company organized in 1922, and the financing was effected by the sale of 44,810 shares of $3.50 convertible preferred shares at $50 a share and 261,349 voting-trust certificates for common stock at $26 per share. The offering circular presented the following exhibit of earnings from the constituent properties:

Year	Net after federal taxes	Per share of preferred	Per share of common
1925	$172,058	$3.84	$0.06
1926	339,920	7.58	0.70
1927	563,856	12.58	1.56
1928	1,021,308	22.79	3.31

The subsequent record was as follows:

1929	812,136	18.13	2.51
1930	*179,875(d)*	*4.01(d)*	*1.81(d)*

In 1931 liquidation of the company's assets was begun and a

total of $17 per share in liquidating dividends on the preferred have been paid up to the end of 1933. (Assets then remaining for liquidation were negligible.)

This example illustrates one of the paradoxes of financial history, *viz.*, that at the very period when the increasing instabil-ity of individual companies had made the purchase of common stocks far more precarious than before, the gospel of common stocks as safe and satisfactory investments was preached to and avidly accepted by the American public.